Management & Marketing (2009) Vol. 4, No. 3, pp. 111-126.

CONFLICTS OF INTEREST'S MANAGEMENT WITHIN CREDIT RATING AGENCIES

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Abstract. *The recent financial crisis triggered by the spectacular drop of the prices of financial instruments backed by subprime loans brought back into spotlight the role played by the credit rating agencies (CRAs) in the structured finance field. Their importance grew exponentially along with financial globalization and received a substantial support from the Basel Committee II whose newest regulations regarding the risks involved by certain financial assets were tied to ratings issued by specialized institutions. Throughout the time, the regulators took appropriate measures to ensure that the problems raised by the rating activity are avoided – loose competition, lack of transparency, potential conflicts of interest and rating-depending regulation.*

This paper tried to identify the main conflicts of interest which arise in the rating issuance activity and to outline the means that generate the potential incentives to exploit those conflicts; an important weight was put on the „reputational capital" theory which implies the fact that under the right circumstances, a reputation mechanism that works properly will deter low quality ratings.

It tried to follow the correlation between the evolution of the legal framework and the impact on ratings quality, looking to identify remedies in order to avoid and remove conflicts of interest for this specific domain. Based on empirical evidence, the influence of conflicts on market informational flow was put under scrutiny and the long term implications on financial market environment were assessed.

Keywords: conflicts of interest, credit rating agencies, information asymmetry, Sarbanes-Oxley Act, subprime crisis.

1. Introduction

Recent corporate scandals and dramatic falls of stock prices intensified investors' worries and put pressure on regulators regarding the potential conflicts of interest within the credit rating agencies who, instead of providing market with accurate information, it had interest to deceive or hide them for their own personal gain.

Conflicts of interest take place at the moment when a financial services provider or an agent within the firm use the information he has access to for its own personal interest. The experience gained by the rating activity along with the capacity of collecting and using the information provided by clients, gives CRAs a competitive advantage in the process of ratings issuance and offers them a special status in creating an informational flow in financial markets.

Lately, conflicts of interest were put under scrutiny because a decrease in informational flow in financial markets leads to a distortion of its perception and jeopardize the process of channeling financial flows to the most appropriate investment opportunities; conflicts of interest also raise ethical issues for those involved in this process. They generate incentives for financial services providers and its employees to hide or provide false information thus hurting their own clients.

Ratings play an important role in pricing debt instruments and assess if a specific issue is suitable to be part of a certain type of portfolio. Changes in ratings began to be used more and more as triggers in financial contracts, thus a lower rating can imply the need new collateral, an interest rate adjustment and even the termination of a contract. Policymakers use ratings as a method to determine the quality of institutional investors' portfolios by assessing their risk exposure and capital requirements. Companies structure their debt so that they can achieve a certain rating; for this purpose, some even create special investment vehicles so that they can lower the cost of capital.

2. Content

Alongside with financial system globalization in the last decades, the importance of ratings met a new demand. *Ratings* are grades given by specialized agencies which assess the creditworthiness of a company or a government and measures its capacity to meet payments. It can assess debt for various tenors with a range starting from the best quality (rating AAA) and finishing with the worst (rating D). At the beginning, rating agencies' task was to assess the debt of companies which wanted to raise capital by issuing bonds on capital markets. These ratings' main goal was to differentiate the financial risk embedded by those issues thus allowing companies with sound financial record to keep a low cost of its debt. Further in time, CRAs' assessments became more sophisticated covering insurance companies, warrants and mutual funds.

During the financial crisis in 1997-1998, CRAs were blamed because they weren't able to identify in proper time the deterioration of banks' balance sheets and furthermore because they were too much in a hurry to lower the ratings of the countries involved, thus multiplying the initial problems (Herrero, Gyntelberg, Tesei, 2008). Enron demise in December 2001 was the one that brought for the first time into spotlight the activity of CRAs; Enron enjoyed investment grade rating until four days before it declared bankruptcy. Its business strategy and financial structures, especially the out-of-balance-sheet investment vehicles, were focused only on maintaining a high rating (Mishkin, Stanley, 2006). US Congress Committee in charge with investigating Enron bankruptcy concluded that CRAs showed „… *a disappointing lack of involvement in assessing and managing company' risks…"*

As a consequence, US government passed Sarbanes-Oxley Act which mandated US Securities and Exchange Commission (SEC) to issue *The Role and*

Function of Credit Rating Agencies in the Operation of the Securities Markets. This report has two parts:

The first part identifies the potential sources of conflicts of interest within CRAs (SEC, 2003);

The second part proposes possible remedies for those conflicts (SEC, 2003).

The conclusions of the report were the fundament for the further regulations within the rating activity and tried to answer the following questions:

Should CRAs make public more information regarding the fundaments their decisions or the creditworthiness of the companies rated?

Should improved procedures be put in place in order to prevent and eliminate potential conflicts of interest?

Should ratings be taken into consideration when issuing new regulation?

Should the current regulations regarding CRAs be changed?

CRAs play an important role in decreasing information asymmetry on the capital markets. These asymmetries take place due to the fact that potential investors lack the information or the capacity to asses properly the creditworthiness of the issuers. The issuers know all the details about the financial instruments they want to sell but they don't want to share them with the potential investors.

CRAs act as delegate monitors for the investors; some of their main advantages are as following:

They can allocate more resources than individual investors and they have the expertise in assessing the creditworthiness of the issuers;

They have access to information which are not available to the general public;

If they are perceived as independent their ratings will have a bigger influence on the market.

If CRAs are used by a bigger number of investors, they can avoid a part of the costs involved by multiplying the information. If each individual investor will be capable of performing the proper analysis, it will be a waste of resources from the social standpoint. Companies are willing to share confidential information with CRAs based on the assumption that the last ones, taking into account the fact that they don't own shares of that respective company will use the information only to set up the proper rating for the company, rating which will be available for all the market participants at the same time. The lack of direct financial involvement makes CRAs' reports more valuable and a good reputation is a premise for an independent and correct assessment of the soundness of a financial institution.

Before 1970, CRAs revenues were exclusively obtained from the subscriptions of those willing to acquire data regarding companies' ratings. In 1970's, main CRAs began asking for fees from those who wanted their issues to be rated. The answer to the question if there are real conflicts of interest in this way of conducting business can be found in the information asymmetry problem. Technological changes, like the possibility of making photocopies at a very low cost, made relatively easy information distribution. Market participants were capable of acquiring information regarding various ratings without having to pay for it; "free-rider" problem became a widespread issue. Following these facts, CRAs weren't able to get the same amount of revenues from selling the information regarding the ratings they issued; the solution of the problem was to ask issuers to pay for the ratings, a business model that still stands nowadays.

CRAs were always perceived as an important tool in the hand of investors; ratings were used by investors as methods of evaluating the soundness of financial instruments they were interested in. The debtors, so-called *blue-chips,* are the potential beneficiaries of a functional rating system; as long as information asymmetry exists, the blue-chips debtors will face problems in certifying the quality of their liabilities and will be forced to pay a premium to the investors to compensate for the uncertainty that dominates this issue. An independent and reliable assessment will allow this quality to be certified thus lowering the cost of financing. There might be an incentive for the issuers of medium quality instruments not to put that much weight on the rating process; once a high quality issue has been rated, all the issuers whose instruments fall below this category will not be interested in having them rated. The regulators, as part of the oversight of financial intermediaries, have taken action to ensure that the rating process works properly. They want to monitor financial intermediaries so that:

- The risks taken by the last ones are properly assessed, managed and disseminated;
- There is sufficient capital to cover the risks and protect certain classes of investors (e.g. savings accounts owners).

A rating has the advantage of being the simplest modality of an independent assessment of financial creditworthiness. This advantage will be useless if the information acquired will not be trusted when:

- CRAs will duplicate information obtained from other sources;
- Their assessment will be biased;
- The confidence in these assessments will come due to a special status given by regulators, thus hurting CRAs' independence.

When assessing the creditworthiness of a company, *information asymmetry* implies the fact that both issuer and investor have a common interest in rating that specific issue. Even though only issuers pay for this service, at the moment when it benefits from a standardized rating, the investors are willing to accept a lower yield; thus the issuers can use the difference to pay for the services provided by the rating agencies.

Even though the above mentioned arguments explain how rating agencies did manage to replace the business model based on subscriptions with the one based solely on fees paid by issuers, they cannot explain with accuracy the following evidences:

- Why the main agencies (Standard & Poor's and Moody's) keep rating almost all issues outstanding irrespective to whether they were made on a contract basis or free of charge;

> Why almost 98% of the issuers whose issues were rated paid for this service[1] (Crocket, Harris, Mishkin, White, 2003).

A reasonable explanation could be that issuers are afraid that lack of fees will imply a lower rating. SEC reported that series of cases where CRAs were charged for using their privileged position in their relationship with certain issuers in order to determine the latter to pay for rating services; in the end, there were no convictions in this respect. Even in the absence of this kind of behavior from CRAs there are some other reasons that made issuers pay for ratings; we mention here the case when a company has knowledge of some information that favors its future issues but is not capable or unwilling to make it public. When this information is sent to a rating agency, the last one will have a positive feedback by issuing a favorable rating, without sharing that confidential information with the market. The companies which pay for ratings will have access to future similar services and, by supplying additional information, will positively influence further ratings.

Another aspect worth mentioning is the legal framework set up by the policymakers regarding CRAs activity and the certifications an agency will have to obtain in order to activate within this field. Even though at the very beginning there were no formal regulations regarding rating process, once the market developed a new type of risk evolved: *rating shopping*. In 1975 SEC introduced the "nationally recognized statistical rating" concept; the fact that some agencies got this recognition influenced the competitive structure of the industry. At this moment there are only three agencies descending from those established a century ago; this degree of concentration is a reflection of the benefits of economies of scale and scope and it reflects industry' access barriers.

Just because at this moment ratings are heavily used and the issuers are willing to pay to use them doesn't necessary imply the fact that CRAs bring new value by offering these services. Market practices and regulatory oversight can generate a high demand for ratings but this is independent of the effective value of the ratings. In analyzing CRAs contributions some other methods of assessing the quality of the ratings should be used; one of them could be rating accuracy. A *rating* is a method which assesses the probability that an entity will meet its payment obligations and the correlation between ratings and historical default probabilities represents one of the main methods of assessment. Evidence (Federal Deposit Insurance Company Working Papers Series, 2002) suggests the fact that, in spite of cases like Enron, there is a close connection between ratings and default probabilities. As we can see in the table below, default probabilities are inverse correlated with ratings (the higher the rating, the lower the risk of default):

Table 1

Correlation between ratings and default probabilities

S&P's rating	Historical default probability between 1981–1999 (%)	Default probability rate in 2000 (%)
AAA	0.00	0.01
AA+	0.00	0.02
AA	0.00	0.03
AA-	0.03	0.04
A+	0.02	0.05
A	0.05	0.07
A-	0.03	0.09
BBB+	0.13	0.13
BBB	0.22	0.18
BBB-	0.29	0.31
BB+	0.57	0.53
BB	0.89	0.93
BB-	1.14	1.57
B+	2.66	2.64
B	8.46	4.46
B-	10.19	7.52

Source: *Brand, Bahar,* 1999, p. 15; *Wyman & Company,* 2000, p. 29.

In spite of these evidences, the above correlations cannot assess the value of the information provided by CRAs:

In the first place, these correlations don't show how much ratings add value on top of some other indicators of credit quality (e.g. interest rate spreads or analysts' research). Some analysis show the fact that their value added can be even smaller taking into account the fact that few professionals are involved in rating process (at Moody's, an analyst is in charge with no less that 35 issues) (Partnoy, 1999);

In the second place, while the rating is a reflection of default risk at a certain moment in time, the correlation between ratings and default probabilities can change over time thus making rating more and more inaccurate. If a rating should assess default probability, their correlation should be stable.

A sound proof that the market values ratings can be found in the way it reacts to rating changes. If ratings offer additional information to that already existed in the market and reflected in the actual capital market prices, is to be expected that market will act accordingly to changes in ratings; as we can see in the below table, ratings are not even distributed for changes in ratings (Jorion, Zhang, 2006):

Tabel 2

Ratings distribution

Rating category	Rating decrease			Rating increase		
	Starting from	No.	%	Starting from	No.	%
1	AAA and AA	46	3.85			
2	A	182	15.23	A	38	10.53
3	BBB	238	19.92	BBB	74	20.50
4	BB	155	12.97	BB	97	26.87
5	B	388	32.47	B	125	34.63
6	Below B	186	15.56	Below B	27	7.48
Total		1.195	100.00		361	100.00

In the case of rating decrease, 15.56% of the sample is rated below B; similar, the percentage is 7.48% for rating increase. In fact, for more accuracy, the comparison should be made between a decrease of a certain category and an increase of the next inferior one. For example, taking into consideration a decrease from B to CCC, the equivalent is from CCC to B and the respective percentages are 32.47% for decrease and 7.48% for increase.

Another problem which arises is that of the reciprocal influence between rating change and the quality of an issue; a rating decrease doesn't necessary means a lowering in the creditworthiness of an issue but it may for sure be a cause a future increase in the cost of debt for the respective company. We have to take into account that in last years ratings were used as covenants in some issues and a change in rating can lead to a change in the underlying contract; these triggers played an important role in the bankruptcies of Enron and WorldCom. A rating decrease will lead to a worsening perspective on the creditworthiness of a company more than a gloomier forecast will do after being identified by the rating agency and disseminate to the market.

A powerful example regarding ratings influence is the one from 1982, when Moody's tripled the number of outstanding rating categories adding „+" and „-" as suffixes to its existent ratings (Liu, Seyyed, Smith, 2003). Even though falling into one of the new categories didn't mean an effective change in creditworthiness of the respective issues, the market perceived the change as a flow of new information in the market. This perception determined price fluctuation on capital markets which stands a strong proof that market values ratings.

Potential conflicts of interest in rating industry are created by the fact that there are several end users of ratings whose interests can diverge on the short run. Investors are interested in unbiased assessments of new issues while issuers are interested in favorable ratings that will allow them to get a cheaper cost of financing. Regulators are interested in:

A stable correlation between ratings and default probabilities;
Avoiding moral hazard;
Promoting a competitive environment.

Rating agencies, as profit focused entities, have their own interest in maximizing profits and market share, which creates itself a potential conflict of interest. As mentioned previously, the business model based on fees represents a conflict of interest; CRAs could be susceptible of according favorable ratings in quest for new sources of income. Taking into account that the majority of bond issues are rated and disseminated to the market even if issuers didn't ask or pay for it, the following question is raised: for what do issuers think they pay fees? Only the idea of a charging a fee in exchange for favorable rating would jeopardize CRAs activity by hurting their reputation.

There is a low probability that a conflict of interest will show up that obviously to the market, like we can see in the following example (Butler, Rodgers, 2003). In 1992 Jefferson County - Colorado School District case draw public attention regarding potential conflicts of interest within rating agencies. In October that year Jefferson County hired Standard & Poor's to rate its new bond issue; the rating given was AA. At the same time, Moody's gave an A2 unsolicited rating, rating which was far lower than that given by Standard & Poor's. As a consequence, Jefferson County brought Moody's in court, claiming that the last one issued an unsolicited report containing an inferior rating following the fact that their services weren't demanded. Jefferson County asked for charges amounting $770.000, the equivalent of the additional cost of financing of the respective issue. Moody's rejected all charges claiming that according to the Fifth Amendment has the right to freely express its opinion even though this might affect the business of a company. SEC initiated an inquiry to verify if Moody's action was strictly addressed to Jefferson County or was a common practice within the agency. One of the measures taken by SEC, following an investigation of the US Department of Justice, was that CRAs were forced to make public whether the ratings were solicited or not.

We can identify two mechanisms that can generate conflicts of interest:

- The first one is tied to analysts compensations; they are paid in respect with the volume of ratings they issue thus being stimulated to rate as many issues as possible which can lead to a lax attitude regarding rating process;
- The second one is tied to the bias analysts have when rating an issue after the financial stimulus has disappear. Within an experiment (Butler, Rodgers, 2003), an agent was involved in a transaction as a supporter of one part and then placed in a position where it didn't have direct financial involvement and asked to judge objectively. The evidence showed that the agents tend to adopt o position favorable for the part they initially worked for.

Another potential source of conflicts is that CRAs started providing auxiliary services like debt structuring, services whose main goal is to lower the cost of financing; these services are similar to those provided by audit firms. CRAs began experimenting this field as a result of the increase demand from companies looking to structure its debt so it can achieve a higher rating. If CRAs are paid for these kinds of services and at the same time they are rating providers, they will be put in the situation of evaluating their own work.

A conflict of interest can be found in the weight put by the existing legislation on ratings seen as standardized methods of evaluating creditworthiness of a company. In the race for the best rating, issuers are tempted to choose the agency that offers then the highest one (White, 2004, p. 8). For agencies, the weight put on ratings as benchmarks for financial contracts shows their importance and recognize the value of their work. On the other hand, using ratings as contracts covenants can imply too much importance given to this kind of assessment, putting their accuracy and efficiency on the second plan.

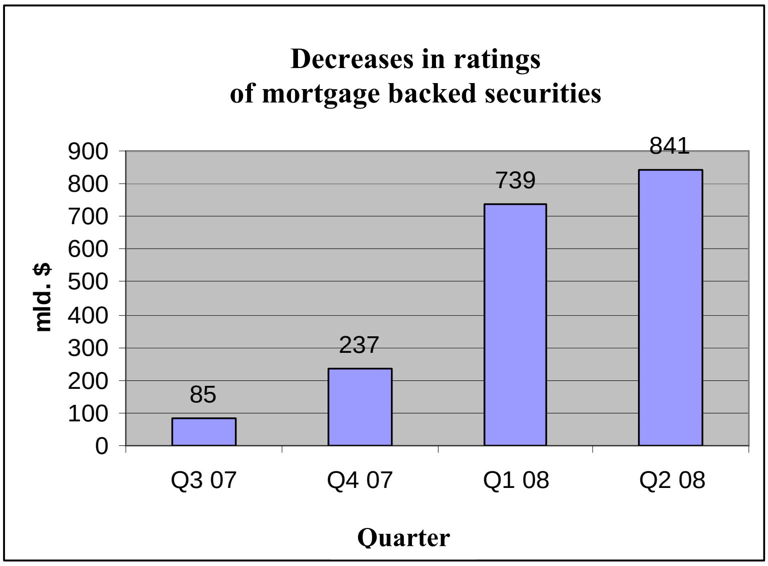
The degree of concentration of the industry is a possible source of conflicts. In US for example, there are few agencies recognized by the supervisory forum (Vincentelli, 2007, p. 16) and, out of those, two have a significant market share: Standard & Poor's and Moody's Investor Service. The combination between the economy of scale and regulatory requirements is in favor of the oligopoly created by these two agencies and represents a barrier hard to overcome by competitors.

Scarce competition has double effect in the industry:

- On one side, it reduces conflicts of interest because the agencies, by lacking competition, will be less under the presure of gaining market share; aditional clients are to come if agency's reputation remains intact;
- On the other side, as long as they have a strong position within the industry, agencies might not have the strongest incentives to provide clients with the best services. They could allocate less resources in the rating process (calitative and quantitative) than their fees will worth. Agencies' profit margin is very big (almost 50% in Moody's case) which allow us to see a gap between the services provided and fees paid for it.

The recent global financial crisis which started in the middle of 2007 had its roots in the US subprime crisis and threatened the financial stability of the main investment bank in US (e.g. Lehman Brothers, Morgan Stanley, Goldman Sachs etc), of some European banks (e.g. Fortis, ABN Amro etc), of the biggest insurance company (e.g. AIG) and to a series of financial institutions whose main field was providing mortgages (e.g. Fannie Mae, Freddy Mac, Northern Rock etc.), thus starting a spiral of negative expectations followed by a dramatic fall of stock exchange indices.

The subprime loans were the product of the demand for financing from people with bad loan record and carried a higher interest rate than the average loans; the higher interest rate charged is a reflection of the higher default probability. The outstanding volume of the subprime loans was estimated to \$1.300 billion. In 2007, the subprime loans amounted roughly 6.8% of the mortgage market (the percentage was 10% between 2001 – 2003 and 18% – 21% between 2004 – 2006) (http://en.wikipedia.org/wiki/Subprime_mortgage_crisis). Only between October 2007 – March 2008 CRAs downgraded a series of mortgage back securities whose value was around \$1,9 billion as seen in the graph below.



Source: *http://en.wikipedia.org/wiki/Credit_rating_agencies_and_the_subprime_crisis, Accessed on April 12, 2009*

Figure 1. Decreases in ratings of mortgage backed securities

Until July 2008, Standard & Poor's downgraded 902 tranches of financial instruments and collateralized debt obligations backed by American mortgages which originally carried AAA rating; following this action, for 466 out of those instruments, the new rating attached was a speculative one.

A study issued by Fitch showed that 97% of debt structures defaults were among companies with US background (Mason, Rosner, 2007). The outstanding volume of US mortgages owned by persons with bad loan record grew from $35 billion in 1994 to $625 billion in 2005. The brokerage fees of the companies that structured, sold and traded these instruments were huge, thus implying that rating agencies took their part of the profit. For example, Moody's revenues grew from $159 million in 2000 to $705 million in 2006, most of the part due to debt structuring services (McLean, 2007).

The hearings of the oversight committee of the rating agencies revealed that the top managers of the main agencies – Standard & Poor's, Moody's and Fitch – earned bonuses in 2008 of around $80 million while the ratings issued by the companies they lead deceived investors whose wealth was reduced by billions of USD. The value of the mortgage backed securities with AAA rating, considered to be the safest one, drop with 70% between January 2007 and December 2008 (London Summit, 2009).

Confidential reports analyzed by the Waxman Committee and made public during the hearings of the oversight committee of rating agencies indicate that agencies' executive members were aware all the time of the precarious value of the ratings issued. An internal email from an employee of a rating agency stated that "…*it could be structured by cows and we would rate it"* and „*…let's hope we are all wealthy and retired by the time this house of cards falters"* (Pelosi, 2008).

Investment banks that securitized these high-risk carrying loans looked for solutions to get rid of them out of their balance sheets and the most appropriate investors found were pension funds and insurance companies; one drawback of the deal is that the last ones could only invest in instruments which carry an investment grade rating. To meet this requirement, a series of mortgage backed securities were created, their success depending only on the rating they carried. CRAs role became crucial in this process and they got more involved taking into account that they were charging fees from issuers to get their issues rated.

CRAs role wasn't a passive one and limited in expressing only an opinion on the creditworthiness of an issuer. According to them (Lacroix, 2007), their role was *an iterative and interactive one* and consisted in informing issuers on *the requirements needed to achieve the desired ratings for their issues* and, on a broad measure, *the recommendation of a debt structuring that help issuers in getting the desired rating*. In other words, CRAs helped issuers to obtain ratings that will allow them to sell the instruments to unadvised institutional investors.

„These fears can be justified only in a market where there are an important number of players which will lead to a more relaxed approach towards rating process in order to attract customers. As long as there are strict defined criteria of authorizing and regulating CRAs and a proper monitoring from specialized institutions, we believe that an objective assessment can be ensured to reach a higher professional standard. Thus it is less likely to believe that big international companies, like Coface, will risk their reputations by issuing ratings unrelated to the real creditworthiness of a debtor" was Coface answer, the only CRA with a subsidiary in Romania, to the fears of European Union regarding the efficiency of the rating agencies' business model based on fees (Vasilache, 2008).

In November 2008 the European Commission approved the reform which stated that all CRAs that activate on European territory will be forced to adopt Brussels' regulatory requirements. Alongside with the obligation of disseminating the methodologies, models and hypothesis assumed when assessing the creditworthiness of a debt, the agencies will also be under the supervision of a series of monitors appointed by the European Commission. CRAs will have to prove that there are no conflicts of interest involved when performing a rating process and to make public which are the first 20 clients ranked by the amount of fees paid. The new directive will also ban CRAs in providing consultancy services, thus Europe making the first step without waiting for Washington's one. *"The new regulations were made in such a way so that they can insure high quality ratings which will be conflicts of interest free"* European Committee stated while raising subjectivism charges on agencies like Standard & Poor's and Fitch.

„Rating agencies will need authorizations if they want to operate on EU territory; the existing regulations, voluntarily accepted by companies, are insufficient. I want Europe to be pioneer in the field. These rules are necessary for reestablishing market confidence towards rating process" said EU Competition commissioner Charles McCreevy, in a statement where it added that each of the 27 EU members will assign an authority to implement this regulation (Gow, 2008). Under the new rules, agencies will be made responsible for their publicly released opinions and could face EU sanctions when unprofessional behavior in the rating process is proven; in order to become a law, the proposal needs European Parliament vote.

In the local market these issues were handled by the National Securities Commission who issued a series of instructions which, in conformity with the Commissions' Act no. 297/2004 regarding capital markets establishes the criteria rating agencies have to meet in order to be able to assess financial creditworthiness and to rate financial instruments or issuers on the Romanian capital markets (Official Monitor no. 515, 2007):

- Quality and integrity of the rating process;
- Rating agencies' independence and conflicts of interest avoidance;
- CRAs' responsibility towards investors and issuers;
- Creation of a code of conduct in the field;
- Shareholders' independence and moral integrity;
- Rating decision fundaments and its organizational structure.

A series of names in the financial environment like Wilbur Ross, recognized as a rescuer of bankrupt companies, consider that short sellers played an important role in the current financial crisis, but the big part of the blame lay on rating agencies' shoulders which rated companies' stocks and their credit default swaps (Chasan, Ablan, 2008); as those ratings are public information, he even questions the reason of CRAs' existence. At the moment when investors sell short a stock and its price falls, CRAs will assume that is something fundamental in the movement and will have to include this information in the rating process. This downgrading leads to a series of events whose finality is that financial institutions and companies will have to pay more for raising additional capital which can lead in the end to their demise.

The conflict of interest that arises from the fact that issuers pay for ratings is even stronger as they are the main beneficiaries of the ratings and not the investors. Recent studies (Bolton, Freixas, Shapiro, 2008, p. 2) tried to issue a series of proposals for eliminating conflicts of interest within the field but results weren't conclusive:

- A bigger number of agencies will intensify competition but will offer more opportunities for issuers shopping for better ratings;
- Advance payment of rating services will raise chances of a fair rating but will not stop investors to shop for ratings;
- Switching to the model of ratings being paid by investors – as in US before 1970 – will raise "free-rider" problem.

Financial Stability Forum report issued in March 2009 (London Summit, 2009), as a foreword of G20 Summit held in London same year in April, proposed a series of solutions regarding rating activity:

- Enhancing oversight on CRAs' activity in order to prevent conflicts of interest;
- A more strict internal regulation within CRAs to insure that the methodologies used in the rating process are viable;
- Separation between rating activities and other business lines within CRAs (i.e. consultancy on debt structuring);
- Restricting any link between managers' compensations and their department performance;
- Dissemination of the information that constitutes the fundament of the rating process.

3. Conclusions

Practice shows the fact that even though conflicts of interest exists, they are hard to exploit; market can offer incentive for agencies to limit their actions that can create conflicts but can also reduce the value of their services when there is evidence of conflicts. As a reply, financial services providers issue internal regulations to reduce the incentives to exploit conflicts, trying to minimize reputational risk.

One of the factors that contributed to blaming CRAs as the main drivers of the actual financial crisis was the conflict of interest through which the agencies, who were supposed to disseminate to the general public trustful information, had interest in hiding or distorting the reality for their own personal gain. The methods used for assessing the risks embedded by the new financial structures issued by companies left room for arguments and induced a suspicion regarding the methodology used in the rating process.

Where conflicts were evident and perceived accordingly by the market, their exploitation will imply a reputational risk for the respective company whose demand for its services will decrease, thus its profitability. On the long run, losing its reputation represents a risk big enough for the company to try to avoid but on the short run this fact depends only on company's transparency and its internal compensational structure. This fact can be found within CRAs that charge issuers fees for ratings; on short term, CRAs have the incentive to increase its customer base by giving them better ratings, thus helping the last ones to finance cheaper on capital markets. This business approach will lead inevitably to a loss in reputation making CRAs services less valuable.

Another issue brought into spotlight by the recent financial crisis is that of the compensation mechanism of the personnel involved. Compensational structure within a company, if not properly assessed, will lead not only to conflicts of interest but to firm failure.

As a conclusion of this paper and its underlying evidences, a series of recommendations can be made regarding control and elimination of conflicts of interest:

- Enhancing transparency towards the potential conflicts of interest within rating agencies;
- Issuing codes of conduct within agencies in cooperation with regulators;
- Enhance oversight of the activities that show evidence of exploiting conflicts of interest.

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